

Tax Issues Related to PEBB Domestic Partner Insurance

January 1, 2009

IRC Section 152 Tax Qualified Dependents

Employer contributions toward payment for health care are taxable to the employee if they are made for an individual who is not the employee's spouse or dependent child. Employees adding a domestic partner or child of their domestic partner to their employer sponsored insurance must identify their family tax status for the upcoming calendar year. This means that the employee will need to verify whether their dependents are "qualified dependents" under Internal Revenue Code (IRC) Section 152. If the dependent qualifies under IRC Section 152, the employer contribution toward the payment for the dependent's health care should not be treated as additional taxable income to the employee.

Although PEBB uses the term "qualified domestic partner" to define which domestic partnerships are eligible for PEBB benefits, in this document and for determination of income taxation, "qualified" only refers to IRS dependency status. The determination of taxation of domestic partners benefits would only occur for those individuals who meet eligibility for PEBB benefits.

Required Retroactive Tax Treatment

Health Care Authority (HCA) recommends that employees enrolling a domestic partner or the domestic partner's child review their tax status declaration annually during the open enrollment period. The declaration requires the employee to anticipate the dependency status of their domestic partner or domestic partner's child for the upcoming year. It is also important for employees to report any changes in dependency status during the year because IRC Section 152 requires a "look-back" at the dependency status at the end of each calendar year. If dependency changes during the calendar year, a retroactive adjustment will be necessary. Some examples of status changes and how to correct them are identified below.

Example 1 – An employee's domestic partner qualifies as an IRC Section 152 dependent from January 1 through July 31, but ceases to qualify for the remainder of 2008. This requires treating the fair market value (FMV) of the coverage provided for the non-qualified domestic partner as taxable to the employee (subject to federal income tax, social security, and Medicare taxes) for the entire 2008 year. To correct for incorrect treatment prior to notification:

(A) – If notification of the change is received during 2008, it is necessary to collect seven months of federal income tax, social security and Medicare taxes on the FMV of the domestic partner's coverage from the employee and include the collected taxes in your agency's next tax deposit. The next Form 941 filed must reflect the correction and include Form 941c with an explanation. Be sure the Form W-2 provided in January 2009 includes the FMV of the domestic partner's coverage for the entire year.

(B) – If notification of the change is received after 2008, the same corrections as immediately above must be made with respect to social security and Medicare taxes. Federal income taxes cannot be corrected after the calendar year. Be sure the Form W-2 provided in January 2009 includes the FMV of the domestic partner's coverage for the entire year. If Form W-2 has already been filed, file Form W-2c showing the corrected amount.

Example 2 – The employee did not indicate that their domestic partner would qualify as an IRC Section 152 dependent on the tax status form for 2008. However, the domestic partner actually does qualify for all of 2008. This requires that the FMV of the domestic partner's coverage not be treated as taxable income to the employee for the entire 2008 year. To correct for incorrect treatment prior to notification:

(A) – If notification of the change is received during 2008, it is necessary to refund or credit to the employee the social security and Medicare taxes already withheld on the FMV of the domestic partner's coverage during the year. Federal income taxes already withheld on the FMV of the domestic partner's coverage during the year may be refunded as well, although it is not required. The next Form 941 filed must reflect the correction and include Form 941c with an explanation. Be sure the Form W-2 provided in January 2009 does not include the FMV of the domestic partner's coverage for any part of the year.

(B) – If notification of the change is received after 2008, the same steps as immediately above must be taken with respect to social security and Medicare taxes. Federal income taxes cannot be corrected after the calendar year. Be sure the Form W-2 provided in January 2009 does not include the FMV of the domestic partner's

coverage for any part of the year. If Form W-2 has already been filed, file form W-2c showing the corrected amount.

Example 3 – The employee indicates that their domestic partner, who did not qualify as an IRC Section 152 dependent from January 1 to July 31, will qualify for the rest of the year. This requires no changes or corrections, as the domestic partner must qualify for the entire year in order to receive favorable tax treatment.

Example 4 – An employee's domestic partner qualifies as an IRC Section 152 dependent and is properly treated as such from January 1 until her death on August 15. The domestic partner's death does not change her status for the portion of the year during which she was alive and no adjustments will be necessary.

IRS Section 152 Non-Qualified Dependents

Employees adding a domestic partner or the child of their domestic partner who do not meet the IRC Section 152 definition of qualified dependents will have additional taxable income, which needs to be taxed and reported. There will be two taxation issues to be addressed.

The first taxation issue is the state-share premium paid to the insurance carrier. The FMV of the coverage provided for the non-qualified domestic partner and the domestic partner's child, less any after-tax contributions, is taxable to the employee, and subject to federal income tax, social security, and Medicare taxes. The FMV is not subject to retirement. The taxable amounts are to be regularly taxed as part of payroll reporting and reported in employees' paychecks and their annual Forms W-2, Wage and Tax Statements.

The FMV captured will represent the *actual* premium paid by the HCA to the insurance carrier for the coverage selected. Although the state funding mechanism uses a composite employer contribution per full-time equivalent employee, the state payments for insurance coverage are paid on a "tiered" basis and "capped" at a maximum state contribution per tier. The actual state contribution can be captured and reported per tier, reflecting the enrollment of a domestic partner and dependent child.

Premiums for calendar year 2009 are in Appendix A. Tables 1 and 2 represent taxable amounts for non-tax qualified dependents. Both tables reflect the *net* taxable value to employees. The responsible employing agency is to tax the employee the taxable amount based on the appropriate tier in tables 1 and 2 in Appendix A.

The second taxation issue is the treatment of the employee contributions for non-qualified dependents. The part of the employee contributions for non-qualifying Section 152 dependents cannot be deducted on a pre-tax basis because they are not eligible for the IRC Section 125 treatment. Payroll systems will provide a means whereby the employees can continue to have deductions for their own portion of the total contribution pre-taxed if they have opted for this choice. However, that portion of the employee's deduction attributable to a non-qualifying dependent(s) will need to be taken on an after-tax (post-tax) basis. Tables 3-7 with the correct combination of pre-tax and post-tax amounts, depending on the employee's family enrollment, are in Appendix A. Scenarios identified as possible combinations of pre-tax and post-tax contributions are in Appendix B.

"Declaration of Tax Status" Form

Employees are required to fill out a Declaration of Tax Status form to indicate whether his/her domestic partner and any children added because of the domestic partner relationship are an IRC Section 152 qualified dependent or not. The tax status form has a worksheet (modeled from an Internal Revenue Service (IRS) form) to help the employee determine the tax status. The tax status form references the state's Section 125 payroll deductions, established under IRC Section 125. Employees with dependents that do not meet the Section 152 definitions will be able to continue to make their own premium contributions with pre-taxed payroll deductions even though contributions for the dependents must be deducted on a post-tax basis.

IRS Worksheet for Determining Dependent Status

The worksheet attached to the Declaration of Tax Status form has been modeled by HCA on the IRS worksheet in the IRS publication 17, entitled Table 3-1, Worksheet for Determining Support. If employees have questions or would like to see the full text of Publication 17, Chapter 3, they can download this information from the IRS web site. The IRS address is <http://www.irs.gov/pub/irs-pdf/p17.pdf>. Employees can also order Publication 17 by calling the IRS publications request number – 1-800-829-3676.

Who to Contact if You Have Questions

If you have questions related to this document, you may contact the HCA training unit at 1-800-700-1555.

Appendix A – HCA Finance and Administration Final 2009 PEBB Rates

Table 1: Employer Share Medical and Dental 2009 Monthly State Premium Contribution for Medical and Dental for Active Employees Additional Taxable Income for Non-Tax Qualified Dependents' Coverage*			
MEDICAL PLAN	Coverage for Domestic Partner*	Coverage for Child(ren)*	Coverage for Domestic Partner, Child(ren)*
All Medical Plans	\$ 427	\$ 338	\$ 765

Table 2: Employer Share Dental Only Sample chart for dental only enrollment-taxable amount for dependents			
DENTAL PLAN	Coverage for Domestic Partner*	Coverage for Child(ren)*	Coverage for Domestic Partner, child(ren)*
All Dental Plans	\$ 42	\$ 42	\$ 84

*Premiums displayed are rounded to the nearest dollar, consistent with IRS tax reporting. The maximum state contribution (or index rate) is changed annually with the new insurance contracts, currently effective January 1 of each year, for the entire calendar year. The state contribution for the employee is not displayed.

State and Higher Education Active Employee Monthly Contributions (Deductions) for non-tax qualified domestic partners and non-tax qualified dependents

Table 3: Total Monthly Employee Contribution Owed for All Coverage (Pre-tax and post-tax combined)				
<u>Plan Name</u>	Subscriber	Subscriber and Partner	Subscriber and Child(ren)	Full Family
Aetna Public Employees Plan	\$ 112	\$ 234	\$ 196	\$ 318
GHC Classic	\$ 107	\$ 224	\$ 187	\$ 304
GHC Value	\$ 25	\$ 60	\$ 44	\$ 79
Kaiser Classic	\$ 76	\$ 162	\$ 133	\$ 219
Kaiser Value	\$ 33	\$ 76	\$ 58	\$ 101
Uniform Medical Plan PPO	\$ 26	\$ 62	\$ 46	\$ 82

Table 4: Post-Tax Partner Share for "Subscriber and Partner" Tier			
Plan Name	Subscriber and Partner	Subscriber	Partner
Aetna Public Employee Plan	\$ 234	\$ 112	\$ 122
GHC Classic	\$ 224	\$ 107	\$ 117
GHC Value	\$ 60	\$ 25	\$ 35
Kaiser Classic	\$ 162	\$ 76	\$ 86
Kaiser Value	\$ 76	\$ 33	\$ 43
Uniform Medical Plan PPO	\$ 62	\$ 26	\$ 36

Table 5: Post Tax Partner Share for "Full Family" Tier			
Plan Name	Full Family	Subscriber and Child(ren)	Partner
Aetna Public Employee Plan	\$ 318	\$ 196	\$ 122
GHC Classic	\$ 304	\$ 187	\$ 117
GHC Value	\$ 79	\$ 44	\$ 35
Kaiser Classic	\$ 219	\$ 133	\$ 86
Kaiser Value	\$ 101	\$ 58	\$ 43
Uniform Medical Plan PPO	\$ 82	\$ 46	\$ 36

Table 6: Post Tax Partner and Child(ren) Share for "Full Family" Tier			
Plan Name	Full Family	Subscriber	Partner and Child(ren)
Aetna Public Employee Plan	\$ 318	\$ 112	\$ 206
GHC Classic	\$ 304	\$ 107	\$ 197
GHC Value	\$ 79	\$ 25	\$ 54
Kaiser Classic	\$ 219	\$ 76	\$ 143
Kaiser Value	\$ 101	\$ 33	\$ 68
Uniform Medical Plan PPO	\$ 82	\$ 26	\$ 56

Table 7: Post Tax Partner's Child(ren) Share for "Subscriber and Child(ren)" Tier			
Plan Name	Subscriber and Child(ren)	Subscriber	Partner's Children
Aetna Public Employees Plan	\$ 196	\$ 112	\$ 84
GHC Classic	\$ 187	\$ 107	\$ 80
GHC Value	\$ 44	\$ 25	\$ 19
Kaiser Classic	\$ 133	\$ 76	\$ 57
Kaiser Value	\$ 58	\$ 33	\$ 25
Uniform Medical Plan PPO	\$ 46	\$ 26	\$ 20

Appendix B

Scenarios identified as possible combinations of pre-tax and post-tax contributions:

A. Subscriber + Qualified 152 Domestic Partner

Pre-tax employee's entire health insurance deduction¹ (employee + partner)

B. Subscriber + Qualified 152 Domestic Partner + Qualified 152 Dependent Child(ren)

Pre-tax employee's entire health insurance deduction¹ (employee + partner + child(ren))

C. Subscriber + Qualified 152 Dependent Child(ren)

Pre-tax employee's entire health insurance deduction¹ (employee + child(ren))

D. Subscriber + Non-Qualified 152 Domestic Partner

Pre-tax employee's portion of total deduction and post-tax partner's portion
(Also tax employee for \$ value of state's share coverage for non-qualifying partner)

E. Subscriber + Non-Qualified 152 Domestic Partner + Qualified 152 Dependent Child(ren)

Pre-tax employee and child(ren)'s portion of total deduction and post-tax partner's portion¹
(Also tax employee for \$ value of state's share coverage for non-qualifying partner)

F. Subscriber + Non-Qualified 152 Domestic Partner + Non-Qualified 152 Dependent Child(ren)

Pre-tax the employee's portion of total deduction, and post-tax the partner and child(ren)'s portion. (Note: Tax the employee for \$ value of state's share coverage for non-qualifying partner and child(ren))

G. Subscriber + Non-Qualified 152 Child(ren)

Pre-tax employee's portion of total deduction and post-tax child(ren)'s portion.
(Also tax employee for \$ value of state's share coverage for non-qualifying child(ren))

H. Subscriber + Non-Qualified 152 Domestic Partner + Combination of Qualified 152 and Non-Qualified 152 Children

Pre-tax employee's portion of total deduction and post-tax partner and all children's portions.² (Tax the employee for \$ value of state's share coverage for non-qualifying partner and children)

- (1) Any tax status change from/to non-qualifying during the calendar year will require adjustment to a non-qualifying taxable situation for the entire calendar year, including making retroactive tax changes. **Tax status should be re-verified annually to ensure employers accurately report taxable income and take appropriate employment taxes.**
- (2) Since Health Care Authority does not split the premium on a child by child basis, there is no way to separately determine a portion of the employee's total deduction to pre-tax any Qualified 152 children.